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Lessons From the Great Expansion

Yes 'the middle class has shrunk'—because it's getting richer.

By Henry R. Nau

In his State of the Union address this week, President Obama said we shouldn't "settle for a country where a shrinking number of people do really well while a growing number of Americans barely get by."

No one would argue with that. But is it an accurate description of our economy? The production of wealth is not a zero-sum game here at home or in the global economy—never has been.

Between 1980 and 2007, the world economy experienced what I call a "Great Expansion" due largely to the free-market polices that President Obama blames for the last recession. Over those three decades, world GDP grew by about 145%, or roughly 3.4% a year, a rate comparable to the 3.5% per year growth during the golden era of 1950-1973.

Even if we include the downturn of the so-called Great Recession, real world growth, after slipping to 2.9% in 2008 and then declining by 0.5% in 2009, rebounded by 5.0% in

2010. And according to this week's International Monetary Fund forecast, it is expected to grow by more than 4.4% in 2011 and 4.5% in 2012.

None of this global growth came at the expense of growth in the U.S. Taking into account two mild recessions in 1990-91 and 2000-01, the U.S. grew by more than 3% per year from 1980-2007 and created more than 50 million new jobs, massively expanding a middle class of working women, African-Americans and legal as well as illegal immigrants.

Per capita income increased by 65%, and household income went up substantially in all income categories.

Yes, "the middle class has shrunk," as Mr. Obama said while campaigning last month. But not because it's getting poorer, rather because it's getting richer.

According to Stephen Rose of the Georgetown University Center on Education and the Workforce, fewer people live today in middle-class households with incomes between $35,000 and $105,000, while the percentage of households making less than $35,000 has remained the same. Where did the missing households go? They became richer. In the past three decades, the percentage of households making more than $105,000 in inflation-adjusted dollars doubled to 24% from 11%.

Even more importantly, the global surge in growth spread wealth from the rich to the poor countries, creating greater equality in global markets than ever before. Throughout this period, developing countries grew two and even three times faster than developed countries. As a result, the share of world GDP held by emerging markets increased to 22% from 13%, while the U.S. share remained steady at approximately 26%. The "Great Expansion" created a global middle class of some 600 million-800 million people in China, India, Brazil and other developing countries.

What were the policy trends that produced this Great Expansion? Precisely the free-market policies of deregulation and lower marginal income-tax rates that Mr. Obama decries.

President Ronald Reagan's decision to reverse the high-tax, loose-money, and interventionist government policies of the 1970s brought an end to the painful "stagflation" of that decade. Privatization world-wide reversed the growth of government, and new trade rounds were launched to open global markets and roll back protectionism. The Uruguay Round and later the North American Free Trade Agreement liberalized trade in agriculture and services and brought fast-growing emerging markets into the global system. This was combined with the liberalization of private financial markets, creating the global banking system that mobilized massive savings in emerging markets to fuel the industrial engines of the Great Expansion.

Global financial markets could have been better regulated, but President Obama's policies go far beyond any reforms that would bring an end to "too big to fail." His policies shift the emphasis back to public-sector growth while squeezing private-sector initiatives. He raises federal spending to 25% of GDP, favors higher taxes to keep it there, and touts government investment in clean energy and infrastructure to spur economic growth.

Meanwhile, he imposes health-care, regulatory and other costs on the private sector, restricts credit by trashing "fat cat" bankers, and discourages imports by pandering to labor's fears of globalization. Sadly, his policies resemble those that brought on the stagflation of the '70s, not those that ignited the Great Expansion.

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